REVISED DIRECT TESTIMONY AND EXHIBITS OF

DANIEL F. SULLIVAN

ON BEHALF OF

THE SOUTH CAROLINA OFFICE OF REGULATORY STAFF

DOCKET NO. 2019-281-S

IN RE: APPLICATION OF PALMETTO UTILITIES, INC. FOR ADJUSTMENT (INCREASE) OF RATES AND CHARGES, TERMS AND CONDITIONS, FOR SEWER SERVICE PROVIDED TO CUSTOMERS IN ITS RICHLAND AND KERSHAW COUNTY SERVICE AREAS

Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS AND OCCUPATION.

A. My name is Daniel F. Sullivan. My business address is 1401 Main Street, Suite 900, Columbia, South Carolina, 29201. I am employed by the State of South Carolina as the Deputy Director of the Audit Department for the Office of Regulatory Staff ("ORS").

Q. PLEASE STATE YOUR EDUCATIONAL BACKGROUND AND EXPERIENCE.

A. I received a Bachelor of Science Degree with a major in Accounting from the University of South Carolina in December 1998. In February 2005, I began my employment with ORS and since then have participated in cases involving the regulation of telecommunications, electric, natural gas, radioactive waste disposal, and water and wastewater utilities.

Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE THE PUBLIC SERVICE COMMISSION OF SOUTH CAROLINA ("COMMISSION")?

A. Yes. I have previously testified before the Commission on cases involving the regulation of radioactive waste disposal, natural gas, electric, water and wastewater.

Q. WHAT IS THE MISSION OF THE OFFICE OF REGULATORY STAFF?

A. ORS represents the public interest as defined by the South Carolina General Assembly as:

> [T]he concerns of the using and consuming public with respect to public utility services, regardless of the class of customer, and preservation of continued investment in and maintenance of utility facilities so as to provide reliable and high-quality utility services.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

A. The purpose of my testimony is to set forth ORS's findings relative to the review of the rate increase application ("Application") submitted by Palmetto Utilities, Inc. ("PUI" or "Company"). Specifically, I will focus on ORS's recommendations in the following areas:

- Accumulated Deferred Income Taxes ("ADIT");
- Excess Deferred Income Taxes ("EDIT");
- Amortization of EDIT; and,
- Excess federal corporate income tax expense imbedded in Commission-approved rates since January 1, 2018.

Q. PLEASE EXPLAIN THE TAX CUTS AND JOBS ACT ("TCJA").

A. On December 22, 2017, the Tax Cuts and Jobs Act was signed into law. The TCJA contains provisions including, but not limited to, decreasing the federal corporate income tax rate from 35% to 21%, effective January 1, 2018. Many South Carolina utilities under the jurisdiction of this Commission recover federal corporate income tax expenses at a corporate tax rate above 21% because federal corporate income tax is a component of rates approved by the Commission.

On April 25, 2018 the Commission issued Order No. 2018-308, in Docket No. 2017-381-A, which required water and wastewater utilities with operating revenues greater than $250,000 to track and defer in a regulatory liability account the tax effects resulting from the TCJA beginning January 1, 2018 with those impacts to be addressed in the next general rate case.

Q. WHAT ARE THE IMPACTS OF THE TCJA ON PUI AND ITS CUSTOMERS?

A. The impacts of the TCJA are reflected in the following areas:

- A reduction in the federal corporate income tax rate from 34%[1] to 21%;
- A re-valuation of ADIT to incorporate the reduction in the federal corporate income tax rate;
- Creation and amortization of EDIT; and,
- Return to customers of the revenue attributed to the excess federal corporate income tax expense embedded in current rates charged to customers since January 1, 2018.

Q. PLEASE DESCRIBE THE MONETARY IMPACT TO THE CUSTOMER DUE TO THE REDUCTION OF THE CORPORATE INCOME TAX RATE.

A. The TCJA resulted in savings of approximately $1,149,000 to customers in this rate proceeding.[2]

Q. WHAT IS ACCUMULATED DEFERRED INCOME TAX AND WHY IS IT IMPORTANT?

A. Many timing differences exist between when income taxes are collected from customers through rates and when the Company pays those taxes to the United States

[1] Commission Order Nos. 2015-153 and 2018-155 approved rate structures that provided PUI recovery of federal income tax expenses at 34%.
[2] Based on ORS adjustments.

Internal Revenue Service ("IRS"). Sometimes the taxes are paid by the Company sooner than when they are collected from customers (creating a deferred tax asset), and sometimes they are paid by the Company later (creating a deferred tax liability). Deferred tax balances result from book/tax timing differences between recognition of income and expenses. Deferred tax balances are included in rate base as they are a cost-free source of capital provided by the customers. Deferred tax balances, whether assets or liabilities, reverse over time and converge to zero over the life of the underlying item giving rise to the deferred tax balance.

Q. PLEASE EXPLAIN WHY THE TCJA REQUIRES ACCUMULATED DEFERRED INCOME TAX TO BE REVALUED.

A. When the federal corporate income tax rate is reduced, a portion of ADIT will never be paid by the Company. This creates EDIT and indicates the Company's Commission approved rates charged to customers included a higher federal corporate income tax expense than the federal corporate income taxes the Company will pay in the future. The TCJA's reduction in federal corporate income tax rates creates an obligation to return to customers the amount attributed to federal corporate income tax expense that will not be paid by the Company.

Q. PLEASE DESCRIBE THE DIFFERENT CLASSIFICATIONS OF EXCESS DEFERRED INCOME TAX.

A. EDIT is derived from different categories of timing differences, and those categories have differing treatment under the TCJA. I will discuss the treatment of "protected" and "unprotected" EDIT separately.

<u>Protected EDIT</u>

The TCJA requires excess deferred taxes generally associated with property, and specifically connected to the accelerated depreciation of property, to be returned to customers in a manner that mimics the remaining life of the underlying assets that generated the ADIT. This is classified as "protected" EDIT. The IRS requires the Company to return the protected EDIT in a prescribed manner. To do otherwise, could trigger a tax normalization violation causing the Company to lose its ability to accelerate depreciation. The normalization rules require protected EDIT to be flowed back over the remaining lives of the property giving rise to the deferred tax balance.

Unprotected EDIT

The remaining EDIT or "unprotected" EDIT may be treated by the Commission like any other regulatory liability in the rate-setting process. In other words, the Commission retains the discretion to determine the time period over which the unprotected EDIT is returned to customers. Most commissions select a shorter time period for the amortization of unprotected EDIT as compared to the amortization of protected EDIT.

Q. DID PUI PROPOSE TO REVALUE AND RETURN EXCESS DEFERRED INCOME TAX TO CUSTOMERS AS PART OF ITS APPLICATION?

A. No. PUI'S Application omitted a calculation of EDIT related to the TCJA. The Company did propose as part of Company witness Daday's direct testimony a calculation of EDIT and an amortization, or return, of the EDIT to its customers for the protected and unprotected categories as required by the IRS. Company witness Daday also attached MD Exhibit 4 to his direct testimony that details the Company's calculation of EDIT and the schedule of the return of the EDIT to PUI customers.

Q. PLEASE EXPLAIN ORS'S RECOMMENDED ADJUSTMENT TO REFLECT THE IMPACT OF EXCESS DEFERRED INCOME TAX ON PUI'S RATE BASE.

A. The creation of the EDIT regulatory liability is offset by the reduction to the ADIT liability, which neutralizes the impact to PUI's rate base calculation. ORS determined the appropriate amount of the ADIT liability at the end of the test year to be $6,167,747, less the EDIT liability of $1,191,345 (Revised Exhibit DFS-1), for an adjusted ADIT liability of $4,976,402 (ORS witness Seale's Exhibit CLS-1). ORS included the EDIT liability of $1,191,345 with an offset of $44,428, which represents one year's worth of amortization of EDIT, in ORS's calculation of PUI's rate base. ORS's recommendations are reflected in ORS witness Seale's Exhibit CLS-2 as adjustment 14 in the amount of ($4,894,748) and adjustment 15 in the amount of ($1,146,917). Company witness Daday's direct testimony on page 10 states that PUI agrees the balance of ADIT should be reduced for the TCJA but witness Daday does not specifically address the inclusion of the EDIT regulatory liability when calculating PUI's rate base.

Q. PLEASE EXPLAIN ORS'S POSITION RELATED TO THE AMORTIZATION, OR RETURN, OF EXCESS DEFERRED INCOME TAX TO PUI'S CUSTOMERS.

A. The amortization of protected EDIT was calculated using the Average Rate Assumption Method ("ARAM") and the return period was determined using the last year the assets that created the EDIT would be fully depreciated, or 2065. The amortization of unprotected EDIT was calculated using return periods of four (4) years for intangibles, two (2) years for the allowance for doubtful accounts, and twenty-five (25) years for the allowance for funds used during construction. ORS accepts the amortization periods proposed by PUI for EDIT. ORS calculated the first-year amortization of EDIT of $44,428

(Revised Exhibit DFS-1), which should be grossed up for taxes for a total of $59,089. This is shown in ORS witness Seale's Exhibit CLS-2 as adjustment 9 in the amount of ($59,089).

Q. DOES PUI PROPOSE TO REFUND OR RETURN TO CUSTOMERS THE AMOUNT OF EXCESS CORPORATE FEDERAL INCOME TAX EXPENSE EMBEDDED IN COMMISSION APPROVED RATES AFTER THE TCJA REDUCED THE FEDERAL CORPORATE INCOME TAX RATE ON JANUARY 1, 2018?

A. No. PUI did not propose to refund or return to its customers an amount attributed to excess federal corporate income tax expense embedded in Commission approved rates ("excess tax expense") since the federal corporate income tax rate was reduced on January 1, 2018. The Company asserts in the direct testimonies of Company witnesses Daday and Walsh that customers are not due a return of excess taxes collected from its customers due to the TCJA as it constitutes retroactive ratemaking and single expense ratemaking.

Q. PLEASE EXPLAIN ORS'S RECOMMENDATION TO REFUND OR RETURN TO CUSTOMERS THE AMOUNT OF EXCESS CORPORATE FEDERAL INCOME TAX EXPENSE EMBEDDED IN COMMISSION APPROVED RATES AFTER THE TCJA REDUCED THE FEDERAL CORPORATE INCOME TAX RATE ON JANUARY 1, 2018.

A. The TCJA mandated a reduction in the federal corporate income tax rate which caused a material known and measurable change in the Company's federal corporate income tax expense. The Company has collected from its customers since January 1, 2018 federal corporate income tax expense that it will never be required to pay to the IRS. The change in the federal corporate income tax rate was extraordinary and outside PUI's management control. ORS recommends the full benefits of the TCJA enjoyed by the Company be provided to PUI's customers in an equitable and prospective manner. The benefits of the TCJA are meaningful to PUI's customers and customers should receive the full benefits to reflect the January 1, 2018 effective date of the federal corporate income tax rate reduction. ORS recommends the regulatory liability associated with the excess tax expense be refunded or returned to customers.

To provide the full benefit to customers, ORS compared the change in the federal corporate income tax rate embedded in rates and revenue approved by the Commission in Order No's. 2015-153 and 2018-155, which included full cost recovery for PUI's federal corporate income tax expense at the 34% tax rate, and the pro-forma rates and revenue that would result if the federal corporate income tax expense reflected the reduction in tax rate to 21%. This comparison indicates the regulatory liability to be recorded to reflect the impact of the TCJA related to the reduction in tax expense due to the federal corporate income tax rate change is $2,001,430. ORS recommends a regulatory liability in the amount of ($2,001,430) be recorded by PUI to reflect compliance with Commission Order No. 2018-308. The ORS's calculation of the regulatory liability estimated new rates to be effective no later than August 7, 2020. The calculations of the regulatory liability are provided in Revised Exhibit DFS-2.

Q. WHAT TIME PERIOD DOES ORS RECOMMEND FOR THE RETURN OF THE REGULATORY LIABILITY TO PUI CUSTOMERS?

A. ORS recommends the regulatory liability be refunded to current customers over three (3) years through a TCJA Decrement Rider. A three (3) year return period for the regulatory liability equitably balances the benefits to the customer with the impacts to the Company. When the balance of the regulatory liability reaches $0, the TCJA Decrement Rider will expire and be removed from customer's monthly bills. The process for administration of the TCJA Decrement Rider is discussed in ORS witness Hunnell's revised direct testimony.

Q. PLEASE SUMMARIZE OTHER DOCKETS IN WHICH THE COMMISSION HAS ADDRESSED THE IMPACTS OF THE TCJA.

A. In Docket No. 2017-292-WS, the Commission ruled that the EDIT calculation for Carolina Water Service, Inc. ("CWS") was rate base neutral as it was being returned to customers. Further, the Commission determined that the amortization of EDIT was a reduction to CWS's cost of service for purposes of determining a revenue requirement.

In Docket No. 2017-370-E, the Commission ruled that EDIT for South Carolina Electric & Gas Company should be amortized and returned to customers through a Tax Savings Rider. Further, the Commission determined that there were current tax savings that resulted in collections of excess tax expenses that should be returned to customers through the Tax Savings Rider.

In Docket No. 2018-257-WS, ORS and Kiawah Island Utility, Inc. agreed to tax treatment for the revaluation of EDIT as rate base neutral, the return of EDIT to customers as reductions to the revenue requirement, and the return of a regulatory liability comprised of collections of excess tax expense since January 1, 2018.

In Docket No. 2018-319-E, ORS and Duke Energy Carolinas, LLC agreed to similar tax treatment for the revaluation of EDIT as rate base neutral, the return of EDIT to customers, and the return of a regulatory liability comprised of collections of excess tax expense since January 1, 2018.

In Docket No. 2018-318-E, ORS and Duke Energy Progress, LLC agreed to similar tax treatment for both the recalculation of EDIT as rate base neutral, the return of EDIT to customers, and the return of a regulatory liability comprised of collections of excess tax expense since January 1, 2018.

In Docket No. 2018-82-S, ORS and Palmetto Wastewater Reclamation, LLC agreed via a Settlement Agreement to tax treatment for the recalculation of EDIT as rate base neutral, the return of EDIT to customers as a reduction to the revenue requirement, and the return of a regulatory liability comprised of collections of excess tax expense since January 1, 2018.

In Docket No. 2019-64-WS, Order No. 2020-94, the Commission ordered CUC, Inc. to return to its customers excess revenues either through a one-time bill credit, or in two yearly installments. The Commission further ordered that the refund shall be made by (a) refund check, or (b) in a one-time bill credit, or in two yearly installments and that the Company must notify the Commission which option CUC chooses.

In Docket No. 2019-290-WS, Order No. 2020-306, the Commission ordered Blue Granite Water Company to initiate a one-time credit to each customer water and sewer service account to return overcollections of Federal tax expenses accumulated between January 1, 2018 to June 28, 2018.

Q. WILL YOU UPDATE YOUR REVISED DIRECT TESTIMONY BASED ON INFORMATION THAT BECOMES AVAILABLE?

A. Yes. ORS fully reserves the right to revise its recommendations via supplemental testimony should new information not previously provided by the Company, or other sources, becomes available.

Q. DOES THIS CONCLUDE YOUR REVISED DIRECT TESTIMONY?

A. Yes, it does.

Office of Regulatory Staff
Excess Deferred Income Taxes
Palmetto Utilities, Inc.
Docket No. 2019-281-S

Category	Starting Balance EDIT [1]	Proposed Return Period (yrs) [1]	2020 Amortization	EDIT Reduction to Rate Base
Fixed Assets [2]	$ 415,047	per schedule	$ -	$ -
Intangibles [3]	341,339	4	42,667	(42,667)
Allow. for Doubtful Accts. [3]	(30,166)	2	(7,541)	7,541
AFUDC [3]	465,125	25	9,302	(9,302)
Total	**$ 1,191,345**		**$ 44,428**	**$ (44,428)**

Annual Amortization, Grossed Up for Taxes	**$ (59,089)**	to Exhibit CLS-2
Reduction to Rate Base for EDIT	**$ 44,428**	to Exhibit CLS-2

Notes:

(1) - Source - Audit Request #14 - Provided on 02/07/2020, Company witness Daday "MD Exhibit 4"
(2) - Protected Excess Deferred Income Taxes - Return per ARAM or RSGM
(3) - Unprotected Excess Deferred Income Taxes - Return per Commission Discretion

Revised Exhibit DFS-2

Office of Regulatory Staff
Excess Tax Collection Liability
Palmetto Utilities, Inc.
Docket No. 2019-281-S

Line No.	Item	As Approved in Commission Order No. 2015-153 - 34% Tax Rate	Reflect 21% Federal Income Tax Rate
1	Operating Revenues	$ 7,639,810	$ 7,639,810
2	Operating Expenses	4,797,738	4,797,738
3	Taxes Other Than Income Taxes	416,948	416,948
4	Interest Expense	202,788	202,788
5	Taxable Income (L1 - (Sum (L2 through L4))	$ 2,222,336	$ 2,222,336
6	State Income Tax (L5 * 5.0% Tax Rate)	111,116	111,116
7	Federal Income Tax ((L5-L6) * Tax Rate)	717,815	443,356
8	Deferred Income Taxes	22,321	22,321
9	Net Income (L5 - L6 - L7 - L8)	$ 1,371,084	$ 1,645,543
10	Add back: Interest Expense (L4)	202,788	202,788
11	Net Income for Return (L9 + L10)	$ 1,573,872	$ 1,848,331
12	Cumulative Change in Net Income for Return		$ 274,459
13	Retention Factor		75.05%
14	Annual Revenue Impact of Cumulative Change		$ (365,702)
15	Daily Revenue Impact (L14/365)		$ (1,002)
16	**Regulatory Liability Calculation (1/1/18 - 3/6/18)**		**$ (64,128)**

Line No.	Item	As Approved in Commission Order No. 2018-155 - 34% Tax Rate	Reflect 21% Federal Income Tax Rate
17	Operating Revenues	$ 20,955,799	$ 20,955,799
18	Operating Expenses	14,310,374	14,310,374
19	Interest Expense	1,779,510	1,779,510
20	Taxable Income (L17 - (Sum (L18 through L19))	$ 4,865,915	$ 4,865,915
21	State Income Tax (L20 * 5.0% Tax Rate)	243,296	243,296
22	Federal Income Tax ((L20 - L21) * Tax Rate)	1,571,690	970,750
23	Net Income (L20 - L21 - L22)	$ 3,050,929	$ 3,651,869
24	Add back: Interest Expense (L19)	1,779,510	1,779,510
25	Net Income for Return (L23 + L24)	$ 4,830,439	$ 5,431,379
26	Cumulative Change in Net Income for Return		$ 600,940
27	Retention Factor		75.05%
28	Annual Revenue Impact of Cumulative Change		$ (800,720)
29	Daily Revenue Impact (L28/365)		$ (2,194)
30	**Regulatory Liability Calculation (3/7/18 - 8/6/20)**		**$ (1,937,302)**
31			
32	**Total Regulatory Liability Calculation (1/1/18 - 8/6/20)**		**$ (2,001,430)**